

**Testimony Regarding Connecticut's Tax System**

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Connecticut Tax Study Panel

September 16, 2015

Former State Rep. Dyson, former State Sen. Nickerson, and distinguished members of the Panel:

Thank you for the opportunity to testify. We speak today on behalf of Connecticut Voices for Children, a statewide research-based public education and advocacy organization working to advance equitable opportunity for all of Connecticut's children and families.

We testify in favor of tax reforms that will make our state's tax system more sustainable, transparent, and fair for all residents. To achieve these goals, we recommend the panel endorse several commonsense tax reforms:

1. Improve oversight and review of our state's over \$7 billion in tax expenditures;
2. Affirm the adoption of unitary corporate reporting to prevent unfair tax avoidance;
3. Modernize our sales tax base to reflect a 21<sup>st</sup>-century economy;
4. Strengthen the state's Earned Income Tax Credit (EITC);
5. Increase tax fairness by pursuing family-friendly changes to the tax code such as the child tax credit;
6. Pursue property tax reform that focuses on alleviating disparities between municipalities; and
7. Adopt further progressive reforms to our state's personal income tax by raising rates for high-income earners.

Our recommendations to the Panel are guided by the principles laid out by the Panel earlier this year, as follows:

- All tax reforms must be shaped by sound revenue policy that avoid fiscal obsolescence by minimizing volatility and diversifying our tax mix;
- All tax reforms must be transparent and subject to public accountability; and
- All tax reforms should promote distributional equity, reducing the current regressive structure of our tax system.

Our recommendations to the panel are grounded in research.

In addition to our own research concerning the EITC<sup>1</sup>, family-friendly tax reforms,<sup>2</sup> and sound revenue changes,<sup>3</sup> we reference independent reports on the regressive structure of our tax system from the Institute on Taxation and Economic Policy (ITEP)<sup>4</sup> and the state Department of Revenue Services (DRS).<sup>5</sup>

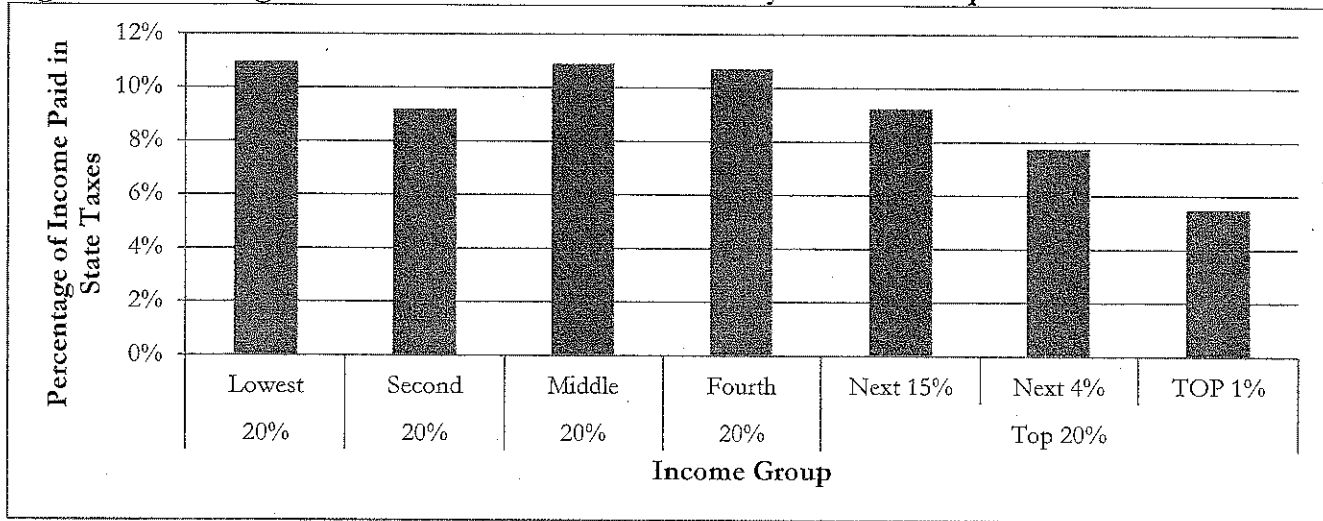
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<sup>1</sup> See Connecticut Voices for Children and Connecticut Association of Human Services, "Connecticut's Earned Income Tax Credit: A Boost to Working Families in Every Town," <http://www.ctvoices.org/sites/default/files/bud13eitchbrief.pdf> (January 2013).

<sup>2</sup> See Defiesta, Nicholas and Gibson, Wade, "Families First, Prosperity for All: Making Connecticut's Tax and Benefit System More Family Friendly," <http://www.ctvoices.org/sites/default/files/bud15dependentexemption.pdf> (February 2015).

<sup>3</sup> See Defiesta, Nicholas and Shemitz, Ellen, "Funding Our Future: Child and Family-Friendly Revenue Options," <http://www.ctvoices.org/sites/default/files/bud15revenueoptionsrev.pdf> (March, 2015).

**Figure 1. Percentage of Income Paid in All State Taxes by Income Group**



Source: Institute on Taxation and Economic Policy (ITEP) Analysis

**Figure 2. Percentage of Income Paid in Individual State Taxes by Income Group**

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Income Range	Less than \$25,000	\$25,000 – \$46,000	\$46,000 – \$76,000	\$76,000 – \$121,000	\$121,000 – \$294,000	\$294,000 – \$1,331,000	\$1,331,000 or more
Average Income in Group	\$13,000	\$35,500	\$59,600	\$95,900	\$169,700	\$572,300	\$3,822,000
<b>Sales &amp; Excise Taxes</b>	6.8%	4.9%	3.8%	3.2%	2.2%	1.4%	0.8%
<b>Property Taxes</b>	5.3%	3.5%	4.8%	5.0%	4.2%	2.6%	1.2%
<b>Income Taxes</b>	-1.1%	1.1%	3.2%	4.0%	4.6%	5.4%	5.8%
Personal Income Tax	-1.096%	1.135%	3.213%	3.960%	4.547%	5.325%	5.640%
Corporate Income Tax	0.014%	0.004%	0.017%	0.021%	0.039%	0.097%	0.162%
<b>Total Taxes</b>	<b>11.0%</b>	<b>9.5%</b>	<b>11.8%</b>	<b>12.1%</b>	<b>11.1%</b>	<b>9.5%</b>	<b>7.7%</b>
<b>Federal Deduction Offset</b>	<b>-0.0%</b>	<b>-0.3%</b>	<b>-0.9%</b>	<b>-1.4%</b>	<b>-1.8%</b>	<b>-1.7%</b>	<b>-2.2%</b>
<b>OVERALL TOTAL</b>	<b>11.0%</b>	<b>9.2%</b>	<b>10.9%</b>	<b>10.7%</b>	<b>9.3%</b>	<b>7.8%</b>	<b>5.5%</b>

Source: Institute on Taxation and Economic Policy (ITEP) Analysis

Our recommendations also reference the 2014 Office of Fiscal Analysis report on tax expenditures<sup>6</sup> and the 2015 analysis of municipal revenue disparities in Connecticut from the New England Public Policy Center.<sup>7</sup> All of our recommendations are consistent with the National Conference of State Legislatures' Principles of a High-Quality State Revenue System.<sup>8</sup>

<sup>4</sup> See Institute on Taxation and Economic Policy, "Connecticut State and Local Taxes in 2015," <http://itep.org/whopays/states/connecticut.pdf> (January 2015).

<sup>5</sup> See Department of Revenue Service, "Connecticut Tax Incidence," <http://www.ct.gov/drs/lib/drs/research/drstaxincidencereport2014.pdf> (December 2014).

<sup>6</sup> See Office of Fiscal Analysis, "Connecticut Tax Expenditure Report," [https://www.cga.ct.gov/ofa/Documents/year/TER/2014TER-20140102\\_Tax%20Expenditure%20Report%20FY%202014.pdf](https://www.cga.ct.gov/ofa/Documents/year/TER/2014TER-20140102_Tax%20Expenditure%20Report%20FY%202014.pdf) (January 2014).

<sup>7</sup> See Weiner, Jennifer and Zheng, Bo, "Measuring Municipal Fiscal Disparities in Connecticut," <https://www.bostonfed.org/economic/neppc/researchreports/2015/neppcrr1501.pdf> (May 2015).

<sup>8</sup> See National Conference of State Legislatures, "Principles of a High-Quality Revenue System" <http://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx> (June 2007).

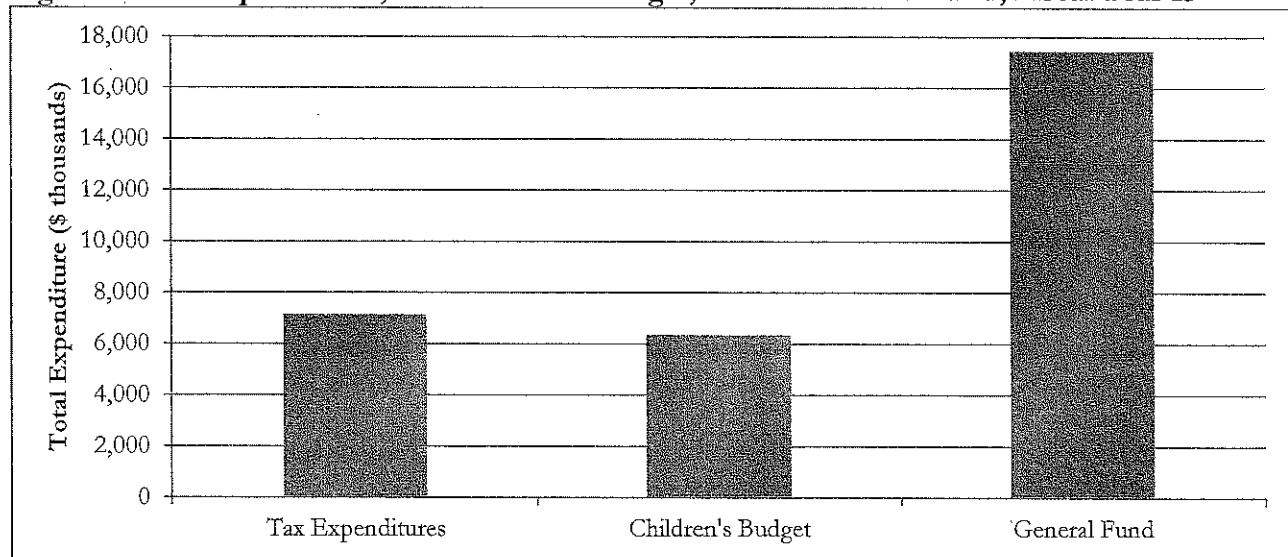
## Our recommendations follow:

### First, improve oversight of Connecticut's tax expenditure system.

Currently, our state spends over \$7 billion annually in tax expenditures, with minimal oversight.<sup>9</sup> Although Connecticut has a statutory mandate that a tax expenditure report be issued by the Office of Fiscal Analysis every two years (to assess fiscal impact, lost revenue and the number of taxpayers benefitting from each exemption), state law does not include other important oversight measures such as regular legislative review and *reevaluation* of each exemption.

The amount Connecticut spent through tax expenditures in the most recent fiscal year, FY15, \$7.1 billion, was over 40% of the total General Fund for that fiscal year. It was also nearly \$800 million more than the total spent on the “Children’s Budget” – the total amount of public funds budgeted to programs such as health, education, and developmental services that support the well-being of children and families in Connecticut.

**Figure 3. Tax Expenditures, the Children’s Budget, and the General Fund, Fiscal Year 15**



Source: Office of Fiscal Analysis Tax Expenditure Report, Office of Fiscal Analysis FY15 Budget Revisions Summary. Note: “Children’s Budget,” constructed by Connecticut Voices for Children, refers to all public spending on programs such as health and education, which benefits children and families.

While all appropriations go through biannual legislative assessment, with an opportunity for public comment, many tax expenditures remain on the books for years without any regular consideration of public benefit. We recommend five specific reforms to reflect national best practices as summarized in a report<sup>10</sup> by ITEP:

- a. **Tax expenditures must include a specific explanation of the intended benefit.** Currently, the rationale given by the state for individual tax expenditure is limited to different categories such as “Expediency” or “Economic Incentive.” Requiring policymakers to be more explicit in setting concrete, measurable goals for each expenditure is an essential step towards accountability.
- b. **Independent analysts must regularly evaluate all tax expenditures, assessing how successful they have been in achieving established objectives and offering**

<sup>9</sup> Office of Fiscal Analysis, Connecticut Tax Expenditure Report, *supra* (2014).

<sup>10</sup> See ITEP, “Five Steps Towards a Better Tax Expenditure Debate,” [http://www.itep.org/pdf/fivesteps\\_1012.pdf](http://www.itep.org/pdf/fivesteps_1012.pdf) (October 2012).

**recommendations for reform.** Currently Connecticut General Statute Section-32-1r only requires a report for those tax credits and abatements “enacted for the purpose of recruitment or retention of businesses.”

- c. **Tax expenditures should be given an expiration, or sunset date, so that lawmakers must determine whether to renew each and every expenditure based on evidence of its success.** While the tax expenditure report does afford some measure of review, lawmakers are not compelled to take action by reconsideration of the continued value of individual tax expenditures. While nontax expenditures must be reassessed biannually, some tax expenditures have been on the book for decades without any legislative action.
- d. **The Governor’s budget should include recommendations about each tax expenditure that has been recently reviewed, stating the public policy rationale for any recommended renewal or revocation.**
- e. **The General Assembly should hold public hearings on all tax expenditures assessed in the biannual review to allow for public input on the merits of each expenditure**

Collectively, these changes would ensure that tax expenditures are held to the same level of scrutiny that is applied to funding for appropriated programs. This would ensure that we treat all spending equitably, hold policymakers accountable for the success of tax expenditures they support, and make our tax expenditure process more transparent to the public.

**Second, affirm last session’s adoption of unitary corporate taxation to prevent tax avoidance and advance fairness.**

Combined (unitary) reporting is an essential requirement in Connecticut in order to counter increasingly sophisticated methods of corporate tax avoidance as well as to level the playing field between multi-state corporations and smaller in-state corporations.<sup>11</sup> Small, in-state businesses often compete with large corporations that engage in substantial tax avoidance. Requiring mandatory combined reporting eliminates one of these tax loopholes, making it easier for locally-based businesses to compete in Connecticut.

**Most states with corporate income taxes, including every state in the Northeast, already require combined reporting.** Currently, 24 of the 45 states with corporate income taxes feature mandatory combined reporting, including New York, Massachusetts and Rhode Island.<sup>12</sup> In Connecticut, corporations may now calculate their tax due with and without combined reporting and elect the method that results in a smaller tax burden, but pay a \$500,000 “preference” tax to do so. Mandatory combined reporting ended this option.

**The vast majority of Connecticut’s largest employers are already subject to mandatory combined reporting in other states in which they operate.** This accounting change will not impose difficult, new administrative burdens on multi-state corporations, as over 85% of them operate in states that require combined reporting.<sup>13</sup> These companies have chosen to locate and remain in states with this reporting requirement.

**Economic growth rates are comparable and even superior in states that require combined reporting.** From 2000 to 2014, 10 of the 15 states that had the best record of retaining manufacturing jobs

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<sup>11</sup>Mazarov, Michael, “Testimony Before the Maryland Senate Budget and Taxation Committee Regarding Combined Reporting, <http://www.cbpp.org/testimony-michael-mazarov-senior-fellow-state-fiscal-project-before-the-maryland-senate-budget-and> (February 2012).

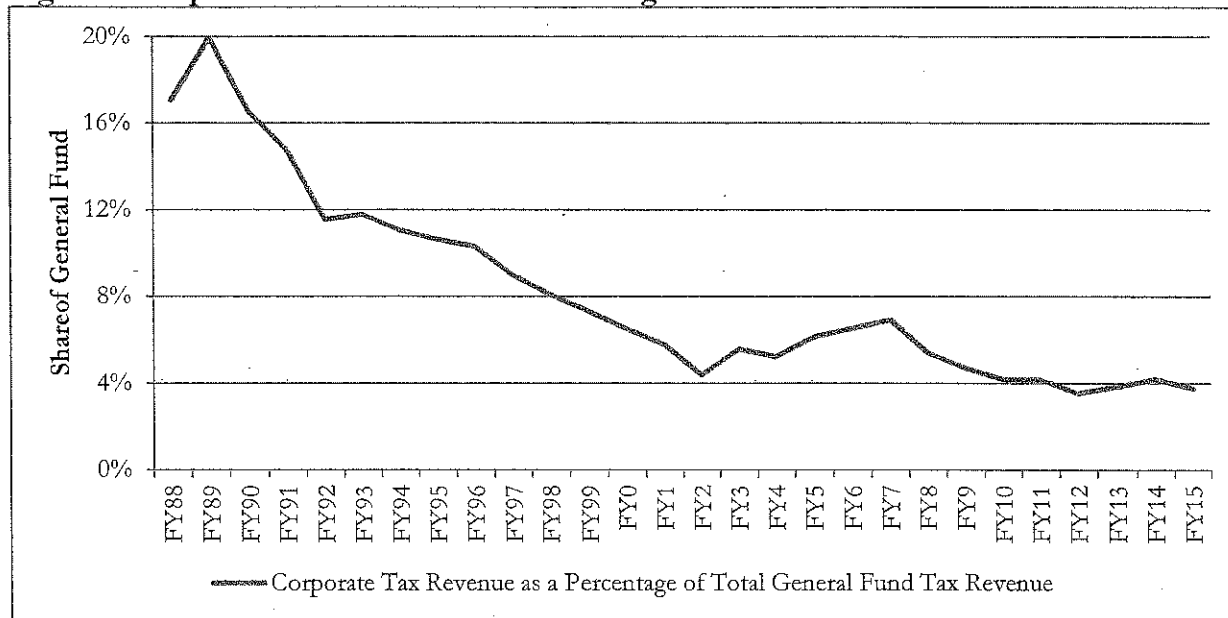
<sup>12</sup> Source: Center on Budget and Policy Priorities Analysis. For more, see: Mazarov, Michael, “Corporate Lobbyist’s Case Against Combined Reporting in New Mexico: A Rebuttal,” (December, 2009)

<sup>13</sup> Source: Connecticut Voices for Children, “Most of Connecticut’s Top Employers Already Are Subject to Mandatory Combined Reporting In Other States,” (March 2010).

required combined reporting, while just two of the 15 states that lost the greatest share of manufacturing jobs were combined reporting states.<sup>14</sup>

Contrary to allegations of high corporate tax rates, the data show that corporate taxation in Connecticut as a share of our total tax revenue has dropped by more than 75% over the last 25 years.

**Figure 4. Corporate Tax Revenue as a Percentage of Total General Fund Tax Revenue**



Source: Office of Fiscal Analysis, "Connecticut Revenue and Budget Data," (July 2009); Office of Fiscal Analysis, Annual Budget Documents, FY10-FY15

### **Third, modernize our sales tax base to reflect the economy of today.**

Our sales tax, based on the economy of the 20th century, must be updated to reflect the reality of today's economy, with an increased share of consumer spending on services versus goods. By including all consumer services in the sales and use tax base, Connecticut would broaden the taxable base from \$68 billion to nearly \$102 billion. The services share of the economy will continue to grow relative to goods, meaning that, everything being equal, failing to tax services will cost the state increasingly more in lost sales tax revenue.

Moreover, by broadening the sales tax base, Connecticut would be able to lower its overall sales and use rate to roughly 4.25% for a revenue neutral change.<sup>15</sup> This change, modeled by ITEP, would directly reflect the Panel's principle of broader tax bases and lower rates and would also improve distributional equity.

By broadening the sales tax base, the state would slightly reduce the regressive impact of the current sales tax. Taxing primarily goods increases the burden on low-income families who spend a disproportionate share of their income on goods. According to the Department of Revenue Service's Tax Incidence Report, the sales tax is tied with the property tax for the second most regressive Connecticut tax (after the excise tax). Expanding the sales tax base to include services, which are purchased more by upper-income residents, would help to reduce the regressive structure of the sales tax.

<sup>14</sup> Source: Center on Budget and Policy Priorities Analysis.

<sup>15</sup> Based on modelling by ITEP in the spring of 2015.

**By including services under the sales and use tax, Connecticut could reduce year-over-year volatility in revenue from tax collections.** According to research, sales tax bases are comprised of many “big-ticket” durable goods like cars and appliance that often decline sharply with economic downturns. Purchases of some services do not vary with the economy, helping to reduce the volatility of sales tax receipts over the business cycle.<sup>16</sup>

**Fourth, the state should restore and strengthen the Earned Income Tax Credit.**

The Earned Income Tax Credit (EITC) is one of the best ways to improve the progressivity of our state’s tax system while supporting children and families in Connecticut. The structure of the EITC ensures it benefits low- and moderate-income residents, particularly families with children. The Department of Revenue Services’ Tax Incidence Report cited the EITC as one of few items in our state’s tax code that improves, rather than harms, progressivity.

**The EITC should be restored to its original amount of 30% of the federal credit, or raised even higher.** The EITC is one of the few tax reforms that has received bipartisan support on both a state and national level, and for good reason. Research this summer found that the EITC is even more effective at boosting employment and reducing poverty than previously believed.<sup>17</sup> If our tax system is to reflect public values, strengthening the EITC should be a top priority.

**Expanding the EITC to include childless workers and young workers would further improve its progressive effect.** Right now, the EITC primarily benefits families with children; the EITC generally phases out for childless workers at much lower income levels, and is roughly a tenth of the amount received by families with children. The EITC is also not available to workers below the age of 25, precluding low-income young people, who stand to benefit most, from receiving support from the EITC. Expanding Connecticut’s EITC to include both of these populations would improve the equity of our tax system.

**Fifth, increase tax fairness with additional family-friendly tax reforms.**

Currently, Connecticut is one of two states that do not adjust its tax code for the cost of raising a child, violating a fundamental principle of tax equity. A majority of states with a personal income tax have a child care credit built into their tax code – a tax credit given to filers who claim child care expenses. Such credits are typically refundable, which makes them more beneficial to low-income children and families. Our failure to include a child care credit in our tax code means that two families of identical incomes, one with two children with significant child care expenses and one with no children, will be taxed identically, despite the differences in their economic situations.

**Enacting a refundable child care credit would improve both horizontal and vertical equity, and reflect Connecticut’s public value of caring for children in our tax code.** Horizontal equity means that a family with children and a family without children that earn the same amount should be taxed differently, reflecting the differences in their finances. Vertical equity, typically expressed in terms of progressive or regressive tax structures, addresses fairness between taxpayers of different incomes; a refundable child care credit would improve both types of equity in our tax system.

**Additionally, there are other options for family-friendly tax reform that would serve similar functions.** A combination of a refundable child tax credit, dependent care credit, or dependent exemption,

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<sup>16</sup> See: Mazerov, Michael, “Expanding Sales Taxation of Services: Options and Issues,” <http://www.cbpp.org/sites/default/files/atoms/files/8-10-09sfp.pdf> (July 2009).

<sup>17</sup> See: Greenstein, Robert, “New Research: EITC Boosts Employment; Lifts Many More Out of Poverty than Previously Thought,” <http://www.cbpp.org/blog/new-research-eitc-boosts-employment-lifts-many-more-out-of-poverty-than-previously-thought> (July 2015).

in lieu of or in addition to a refundable child care credit, would ensure that caring for families is a public value reflected by our tax reform.

**Sixth, pursue property tax reform to alleviate our state's regressive tax burden and to address existing disparities in fiscal capacity across municipalities.**

A graph from the 2014 DRS Tax Incident report highlights the regressive nature of the property tax (which accounted for nearly 45% of total state and local revenues in 2011<sup>18</sup>). This is consistent with the Legislative Program Review and Investigations Committee Report on the state tax system (2006) which compared the effective tax rate across towns (that is, a ratio of taxes paid to the equalized value of property) and confirmed that towns with the highest per capita income tend to have a lower effective rate.<sup>19</sup>

Not only does the property tax ask more of families with the least, it also exacerbates inequities between low- and high-wealth towns, limiting the resources available at the local level to support children and families with the highest need.<sup>20</sup> This contributes to a well-

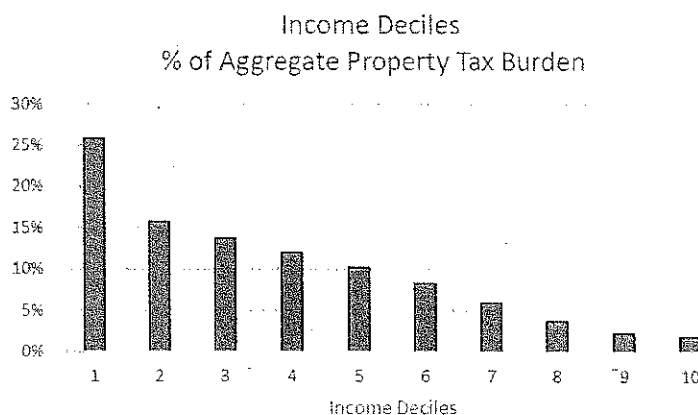
documented cycle of poverty in which young children are not only negatively impacted by living in poverty, but are also harmed by the lower level of services and resources available. Moreover, because Connecticut has a high rate of residential segregation, with a disproportionate share of children of color living in lower property-wealth towns, the disparity in local education funding aggravates existing inequity by race and ethnicity. The differential in educational opportunity is of significant concern for economic as well as moral reasons as demographic changes make the diminished achievement of minority students a significant threat to workforce preparedness.

Reforms to the property tax could include a statewide property tax surcharge on properties over a certain value, dedicating those funds to education finance; a statewide property tax on intangible property (such as stocks and bonds); and/or a circuit breaker that provides property tax assistance when taxes exceed a certain share of a household's income. While most states, including Connecticut, limit their circuit-breaker programs to the elderly and/or disabled, seven states make them available to all property owners and in some cases to renters as well. Minnesota and Michigan, for example, have long-standing circuit-breaker programs with relatively high income ceilings that extend property tax relief to the low- and moderate-income homeowners. This change would reduce the unfair structure of the state's property tax while preventing erosion of existing local funding.<sup>21</sup>

**Seventh, make our personal income tax structure more progressive with higher top rates.**

Our state income tax could be made even more progressive with bracket and rate adjustments to offset other regressive taxes. As one of just two state taxes that is progressive (instead of regressive), the personal

**Figure 5. Aggregate Tax Burden by Income Decile**



Source: Department of Revenue Services Tax Incidence Report

<sup>18</sup> DRS Tax Incidence Report, supra at 2 (2014).

<sup>19</sup> Legislative Program and Review Investigations Committee Assessment of Connecticut Tax Burden, [https://www.cga.ct.gov/2005/pridata/Studies/pdf/CT\\_Tax\\_System\\_F&R.PDF](https://www.cga.ct.gov/2005/pridata/Studies/pdf/CT_Tax_System_F&R.PDF), at 81 (January 2006).

<sup>20</sup> Cf. Measuring Municipal Fiscal Disparities in Connecticut, New England Public Policy Center Research Report 15-1 (March 2015)

<sup>21</sup> See: Fiscal Policy Institute, "Policy Brief: Property Tax Relief (Circuit Breaker)," <http://fiscalfpolicy.org/policy-brief-property-tax-relief-circuit-breaker> (March 2015).

income tax plays an important role in reducing the regressive structure of the rest of Connecticut's tax system. Restructuring the personal income tax so that top rates are higher, and rates for low-income earners are lower, would improve its progressivity, and thus the progressivity of the entire tax system.

Consider, for example, a 4 percent surcharge on incomes over one million dollars. Such a tax would yield nearly \$1.5 billion annually and almost \$600 million would be borne by deductions from federal income taxes.<sup>22</sup> The revenue gain from such a surcharge could be used to offset a decrease in regressive taxes, such as the property tax "circuit breaker" referenced above, in order to maintain a revenue neutral tax reform.

**While some fear that raising the rate on our highest earners would have a negative impact on the economic climate of Connecticut, recent research does not support that claim.** An April 2015 report from the Brookings Institute found that "neither tax revenues nor top marginal income tax rates bear any stable relation – and, indeed, often bear a positive relation – to economic growth rates across states and over time."<sup>23</sup>

**We urge the tax panel to consider these policy recommendations which comply with its overarching philosophical framework as articulated in a memorandum on May 7, 2015.**

Thank you for your time. We would be happy to take any questions.

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<sup>22</sup> Modelling by IETP, September 2015.

<sup>23</sup> Gale and Krupkin, "The Relationship Between Taxes and Growth at the State Level: New Evidence," Brookings Institute, <http://www.brookings.edu/~media/research/files/papers/2015/04/29-relationship-between-taxes-and-growth-gale/gale--taxes-and-growth-42915.pdf>, April 2015.